

TEACHERS' RETIREMENT BOARD
EXECUTIVE COMPENSATION COMMITTEE

SUBJECT: Incentive Compensation Structure

ITEM NUMBER: 3

ATTACHMENTS: 1

ACTION: _____

DATE OF MEETING: February 5, 2003

INFORMATION: X

PRESENTERS: Armando M. Hidalgo
and Christopher Ailman

Executive Summary:

At the October 3, 2002 Committee meeting, the Committee requested the Chief Executive Officer (CEO) and the Chief Investment Officer (CIO) report back on the creation of the criteria and structure of the bonus system for the CIO and the five Investment Directors. After lengthy research, the attached criteria and scale were developed. This is being presented for the Committee's information and comment.

Background:

At the October 3, 2002 meeting, the Committee and Board approved a new salary and bonus percentage for the CIO and five Investment Directors. At that time, the Committee also delegated to the CEO and CIO the authority to set the salaries and establish the bonus criteria and structure for the positions. The Committee requested the staff come back and report once the bonus criteria and structure were developed.

The CIO engaged in lengthy research of the bonus systems across the investment industry, among our peers, and finally in depth meetings with some of the most successful investment firms in the United States. The data sources cover over 300 companies and 560 investment positions. The key sources were a Greenwich Associates & Buck Consulting industry survey, discussions with Ron Keimach of Watson Wyatt, the prior CalSTRS compensation consultant. In addition the CIO met directly with the compensation personnel for Capital Guardian and Frank Russell Companies. The CIO also reviewed a State pension plan compensation survey and the specific plans from the pension plans for the State of Wisconsin, South Dakota, Oregon as well as CalPERS.

Discussion:

The key findings of the research found that the median number of criteria in both the CIO and Senior Investment Officer positions were three components with 50 to 60 percent of the bonus attributable to investment performance. The number of criteria was quite surprising in that 90+ percent of the data points were at two or three components, while CalPERS stood out with over 17 criteria to their plan. The critical element according to Capital Guardian's Compensation and Benefits Vice President, Nancy Fairchild, is to identify which behaviors you want to motivate, design a measurement and weight to each behavior, and finally focus on a time period and measurable results.

The single most important behavior to motivate in these positions is "Alpha" net out performance or value added above a set benchmark, such as a passive index. This can be easily measured at the total portfolio and asset class level. Furthermore, the time period can be spread over several years to match the investment objectives and investment horizon of the Fund. As a result, staff has developed a structure designed to reward long-term performance that exceeds the Board's selected benchmark and desired level of risk. It also rewards teamwork and CalSTRS' portfolio-wide performance that helps melt down and eliminate silos. The additional criterion motivates leadership, collegiality, and mentoring / staff development and reinforces the CalSTRS' Mission and Core Values, as well as, our Goal #5 "Advance policies and practices that ensure a financially sound retirement system while exploring opportunities for innovation."

The Investment staff will be measured against the criteria over a four-year period thus creating a retention value and motivating sustained performance over several years. Additionally, to remove staff's motivation to take on excessive risk, above the Board's desired level, each investment performance scale has a maximum risk level.

Staff believes the bonus system criteria strikes the balance between simplicity and measurability over a reasonable time period which allows us to properly align the incentives with the Board's objectives and the sustained success of the Fund and the CalSTRS Investment branch.

Position: **Chief Investment Officer**

Incentive range: Zero – 40 – 50%

Factor	Weight	Performance Measure	Scale
Total CalSTRS Portfolio Return	45%	Total portfolio return, net of costs, compared to the passive benchmark return weighted at the target asset allocation, rebalanced annually.	-50 to -26 basis points .10 -25 to Zero .25 Every basis point above zero to a max. of 100 basis points is multiplied by: 0.75
Asset Class alpha	25%	The individual portfolio bonus calculation for each Director added together and divided by 5 for a straight average.	The simple average of each Directors portfolio scale.
Personal performance	20%	CEO and Board evaluation based the Fiscal Year Investment Objectives and input from a comprehensive annual review by the entire Investment Branch and personal performance goals factors	Assign a factor rating of zero to 1
Overall System Performance	10%	Overall Strategic Plan accomplishment	Percentage of achievement

The portfolio performance and total portfolio performance are based upon a four-year average return. During the first four years the average is based upon the average return over the period from the closest fiscal year end to the hire date. The subjective evaluation is based on current year performance.

Created January 2003

Position: **Director of Fixed Income**

Incentive range: Zero to 30%

Factor	Weight	Performance Measure	Scale
Fixed Income portfolio alpha (net of fees)	50%	Return of the total Fixed Income Portfolio net of fees and costs, less the Policy Index, to a maximum of 25 basis points.	-4 to Zero basis points .25 1 basis point to a max. of 25 basis points is multiplied by 3
Total CalSTRS Portfolio Return (same as CIO scale)	30%	Total portfolio return, net of costs, compared to the passive benchmark return weighted at the target asset allocation, rebalanced annually.	-50 to -26 basis points .10 -25 to Zero .25 Every basis point above zero to a max. of 100 basis points is multiplied by 0.75
Personal performance	20%	CIO evaluation based upon input from the Board, CEO, a comprehensive annual peer review and personal performance factors	Assign a factor rating of zero to 1

The portfolio performance and total portfolio performance are based upon a four-year average return. During the first four years the average is based upon the average return over the period from the closest fiscal year end to the hire date. The subjective evaluation is based on current year performance.

Created January 2003

Position: **Director of External Equity**

Incentive range: Zero to 30%

Factor	Weight	Performance Measure	Scale
Active External Equity managers portfolio alpha (net of fees)	50%	Return of the active external equity managers, both U.S. and Non- U.S. portfolio net of fees and costs, less the Policy Index, to a maximum of.	-33 to Zero basis points .10 1 to 33 basis points .20 34 to 66 basis points .40 67 to 100 basis points .60 101 to 134 basis points .80 135 and above 1.00
Total CalSTRS Portfolio Return (same as CIO scale)	30%	Total portfolio return, net of costs, compared to the passive benchmark return weighted at the target asset allocation, rebalanced annually.	-50 to -26 basis points .10 -25 to Zero .25 Every basis point above zero to a max. of 100 basis points is multiplied by 0.75
Personal performance	20%	CIO evaluation based upon input from the Board, CEO, a comprehensive annual peer review and personal performance factors	Assign a factor rating of zero to 1

The portfolio performance and total portfolio performance are based upon a four-year average return. During the first four years the average is based upon the average return over the period from the closest fiscal year end to the hire date. The subjective evaluation is based on current year performance.

Created January 2003

Position: **Director of Internal Equity**

Incentive range: Zero to 30%

Factor	Weight	Performance Measure	Scale
Index portfolio management (tracking error)	50%	Target is the tracking error of the Russell 1000 passive index, net of all fees and costs. To control risk, the maximum excess return is 12 basis points	-2 to -1 basis points .20 0 to 2 basis points .50 3 to 5 basis points .75 6 to 12 basis points 1.00 13 to 14 basis points .80 above 14 basis points .50
Total CalSTRS Portfolio Return (same as CIO scale)	30%	Total portfolio return, net of costs, compared to the passive benchmark return weighted at the target asset allocation, rebalanced annually.	-50 to -26 basis points .10 -25 to Zero .25 Every basis point above zero to a max. of 100 basis points is multiplied by 0.75
Personal performance	20%	CIO evaluation based upon input from the Board, CEO, a comprehensive annual peer review and personal performance factors	Assign a factor rating of zero to 1

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Created January 2003

Position: **Director of Real Estate**

Incentive range: Zero to 30%

Factor	Weight	Performance Measure	Scale
Real estate portfolio alpha (net of fees)	50%	Return of the total Real Estate Portfolio, net of leverage, fees, and costs, less the Policy Index, to a maximum of 100.	-50 to Zero basis points .10 1 to 25 basis points .20 26 to 50 basis points .40 51 to 75 basis points .60 76 to 99 basis points .80 100 and above 1.00
Total CalSTRS Portfolio Return (same as CIO scale)	30%	Total portfolio return, net of costs, compared to the passive benchmark return weighted at the target asset allocation, rebalanced annually.	-50 to -26 basis points .10 -25 to Zero .25 Every basis point above zero to a max. of 100 basis points is multiplied by 0.75
Personal performance	20%	CIO evaluation based upon input from the Board, CEO, a comprehensive annual peer review and personal performance factors	Assign a factor rating of zero to 1

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Created January 2003

Position: **Director of Alternative Investments**

Incentive range: Zero to 30%

Factor	Weight	Performance Measure	Scale
Alternative Investment (private equity) portfolio alpha (net of fees)	50%	Return of the total Alternative Investment Portfolio (excluding Credit Enhancement) net of fees and costs, less the Policy Index, to a maximum of 100.	-150 to -100 basis points .10 -99 to -50 basis points .20 -49 to 0 basis points .40 1 to 50 basis points .60 51 to 99 basis points .80 100 and above 1.00
Total CalSTRS Portfolio Return (same as CIO scale)	30%	Total portfolio return, net of costs, compared to the passive benchmark return weighted at the target asset allocation, rebalanced annually.	-50 to -26 basis points .10 -25 to Zero .25 Every basis point above zero to a max. of 100 basis points is multiplied by 0.75
Personal performance	20%	CIO evaluation based upon input from the Board, CEO, a comprehensive annual peer review and personal performance factors	Assign a factor rating of zero to 1

The portfolio performance and total portfolio performance are based upon a four-year average return. During the first four years the average is based upon the average return over the period from the closest fiscal year end to the hire date. The subjective evaluation is based on current year performance.

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